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OCTOBER TERM, 1948.

No. 35

35

GEORGE T. GOGGIN, Trustee in Bankruptcy of the Estate of Kessco Engineering Corporation,

Petitioner,

vs.

DIVISION OF LABOR LAW ENFORCEMENT, STATE OF CALIFORNIA, Statutory Assignee of Certain Prior Wage Claimants,

Respondent.

BRIEF OF THE RESPONDENT.

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DIVISION OF LABOR LAW ENFORCEMENT, STATE OF CALIFORNIA, Statutory Assignee of Certain Prior Wage Claimants,

Respondent.

BRIEF OF THE RESPONDENT.

Opinion Below.

The opinion of the Court of Appeals for the Ninth Circuit [R. 36-39] is reported at 165 F. 2d 155. The District Court did not file a written opinion.

Jurisdiction.

The judgment of the Court of Appeals for the Ninth Circuit was entered December 9, 1947 [R. 39-40]. The petition of the trustee in bankruptcy for a writ of certiorari was filed March 9, 1948, and the writ was granted by this Court on March 24, 1948.

Statutes Involved.

The principal statute involved is Section 67(c) of the Bankruptcy Act of 1898, c. 541, 30 Stat. 544, as amended by the Act of June 22, 1938, c. 575, 52 Stat. 840, Sec. 1:

Section 67(c) (United States Code, Title 11, Chap. 7, Sec. 107): Where not enforced by sale before the filing of a petition in bankruptcy or of an original petition under Chapter X, XI, XII, or XIII of this Act, though valid under subdivision b of this section, statutory liens, including liens for taxes or debts owing to the United States or to any State or subdivision thereof, on personal property not accompanied by possession of such property, and liens whether statutory or not, of distress for rent shall be postponed in payment to the debts specified in clauses (1) and (2) of subdivision a of section 64 of this Act, and, except as against other liens, such liens for wages or for rent shall be restricted in the amount of their payment to the same extent as provided for wages and rent respectively in subdivision a of section 64 of this Act.

Other statutes involved generally are set forth at pages 20-24 in the Appendix of the brief of the United States, and for purposes of brevity are not here repeated.

Question Presented.

By virtue of the provisions of Section 67(c) of the Bankruptcy Act, do the prior wage claimants have priority in payment from the funds remaining in the hands of the trustee in bankruptcy over the statutory lien claim of the Collector of Internal Revenue, where such funds came into the bankrupt estate through sale in the bankruptcy proceeding of personal property voluntarily relinquished by the Collector of Internal Revenue to the receiver in bankruptcy?

Statement of Case.

The facts in this case are precisely as set forth in the STATEMENT on pages 6-9 of the petition for writ of certiorari filed by the trustee in bankruptcy. For emphasis respondent will repeat the trustee's words here:

> "The facts in the case at bar are undisputed.
>
> "The appellant below, respondent herein, accepted as the statement of facts the recitation contained in the certificate of the referee on petition for review in connection with the appeal by the said appellant to the District Court, and from this certificate we quote as follows [Record before Appellate Court, pp. 26-28]:
>
> "'This proceeding began on March 26, 1946. On that date all of the assets, later liquidated by the trustee, were in the physical possession of the Collector of Internal Revenue. The Collector had previously made a seizure of the said assets pursuant to certain tax claims against the bankrupt, which tax claims are specifically described in Exhibit "A" of your Referee's findings of fact, conclusions of law and order, a true copy of which is going up with this certificate. In addition to having made a physical seizure of the said assets, the Collector of Internal Revenue, prior to the commencement of this bankruptcy proceeding, had filed notices of lien with respect to various taxes, including the tax claims set forth in the said Exhibit "A". Pursuant to his legal rights and remedies, by virtue of the said seizure, the Collector of Internal Revenue had conducted a sale of the said assets and had received bids thereon, but the said sale was not completed because the price obtainable was unsatisfactory to the Collector. A second sale by the collector was instituted but was abandoned when the said assets were relinquished to the receiver in this matter, as hereinafter set forth.

"'On March 26, 1946, the day this proceeding began, George T. Goggin, now trustee, was appointed receiver in this matter. He qualified as such receiver on March 28, 1946. Upon his appointment and qualification, the said receiver contacted the office of the Collector of Internal Revenue and conversations were had between the receiver and counsel in the Los Angeles office of the Collector relating to the turning over of the said assets by the Collector to the receiver. Thereafter, the following telegram was received by the Los Angeles office of the Collector of Internal Revenue from J. P. Wenchel, Chief Counsel of the Bureau of Internal Revenue:

> "'"Reference to telephone conversation today with Mr. Webb relative to Kessco Engineering Corporation, bankrupt, no objection by this office to Collector relinquishing personal property to Trustee for sale. Government's lien to attach to proceeds from sale subject to Trustee's expenses including costs of sale.
>
> J. P. Wenchel
> Chief Counsel"

"'The contents of the said telegram were imparted by telephone to the office of the said receiver. No formal acceptance or acknowledgment thereof was made by the receiver. No notice of the telegram or of its contents was given to any of the creditors or other parties in interest in this matter and no notice thereof was given at the time of the trustee's sale of the aforesaid assets. After the said telegram had been imparted to the office of the said receiver, as aforesaid, the said receiver, with full knowledge of the said telegram and of its contents and without any objection thereto, took over the possession of the said assets from the Collector of Internal Revenue. Later

the said receiver, in his capacity as trustee, caused the said assets to be sold at public auction, pursuant to the order of this Court.'

"On October 17, 1946, the petitioner herein filed a petition for order to show cause *re*: Tax & Labor Claimants; dated October 4, 1946, and, pursuant to this petition, an order to show cause was duly issued by the Referee in Bankruptcy on October 18, 1946, directing the various tax and labor claimants to show cause why the said referee should not determine the priority and method of payment of the expenses of administration, tax claimants, and prior labor claimants. Hearing was duly had thereon upon the 30th day of October, 1946; thereafter, the Referee duly signed findings of fact, conclusions of law and an order, finding as follows:

"1. That from the monies in the possession of George T. Goggin, as trustee, there shall first be paid the expenses of administration.

"2. That after the payment of the expenses of administration, the balance of the funds then in the hands of the trustee should be paid to the Collector of Internal Revenue in partial payment of the tax claim for which he had filed and recorded a lien and had seized actual possession of personal property involved, prior to the commencement of the bankruptcy proceeding; the amount of said lien and seizure claims being more than the total of the funds in the hands of the trustee arising from the sale of the physical assets.

"The respondent herein, the Division of Labor Law Enforcement for the State of California, filed a petition for review from the order of the referee and the matter was duly heard before the district judge below.

and the Honorable Campbell E. Beaumont, as said District Judge, duly made and entered an order, on May 21, 1947, confirming the order of the referee above referred to entered on December 12, 1946, and adopting the findings of fact and conclusions of law of the referee.

"From the order of the District Judge the Division of Labor Law Enforcement for the State of California duly filed a notice of appeal and the matter was presented to the United States Circuit Court of Appeals for the Ninth Circuit and finally determined on December 9, 1947, by an opinion filed on that date. This opinion reversed the order of the referee and the District Judge and directed the referee to allow the labor claims represented by the Division of Labor Law Enforcement for the State of California as prior claims to be paid before paying any monies to the Collector of Internal Revenue on behalf of the United States of America, and petitioner now seeks review by certiorari."

Respondent takes issue with and objects to that portion of the statement of the facts in this case as set forth in the STATEMENT of the brief for the United States on page 3, to wit:

"Upon his appointment and qualification, conversations were had between the receiver and counsel in the office of the Collector as to turning over to the receiver the bankrupt's personal property in the Collector's possession. [R. 18.] Pursuant to these conversations, the assets were turned over to the receiver *who accepted the terms and conditions of a telegram from J. P. Wenchel*, Chief Counsel of the Bureau of Internal Revenue, reading as follows [R. 7]:" (Emphasis ours.)

Both Mr. Martin Gendel, counsel for petitioner, and Mr. Edward M. Belasco, counsel for respondent; were present in the courtroom of the referee in bankruptcy at the hearing on October 30, 1946, when the facts were agreed upon, and throughout all appellate proceedings thereafter petitioner and respondent have accepted the statement of facts rendered by the referee in bankruptcy in his certificate as being true and correct; both parties have included the referee's words in their briefs. These words are:

> "The contents of the said telegram were imparted by telephone to the office of the said receiver. No formal acceptance or acknowledgment thereof was made by the receiver. No notice of the telegram or of its contents was given to any of the creditors or other parties in interest in this matter and no notice thereof was given at the time of the trustee's sale of the aforesaid assets."

Summary of Argument.

Section 67(c) of the Bankruptcy Act created priority payment rights for prior wage claims not hitherto granted under bankruptcy law, and the Collector of Internal Revenue became subject to the provisions of that section when he voluntarily entered the bankruptcy proceedings.

Any private agreement between the Collector of Internal Revenue and the receiver or trustee in bankruptcy concerning the attachment of the statutory lien to the proceeds of a trustee's sale, when possession of the personal property was voluntarily transferred to the receiver, would not be binding upon the prior wage claimants.

Under Section 67(c) of the Bankruptcy Act, administration costs and prior wage claims are jointly given priority over statutory liens not accompanied by possession.

ARGUMENT.

I.

Section 67(c) of the Bankruptcy Act Created Priority Payment Rights for Prior Wage Claims Not Hitherto Granted Under Bankruptcy Law, and the Collector of Internal Revenue Became Subject to the Provisions of That Section When He Voluntarily Entered the Bankruptcy Proceeding.

The first thing to be considered is that the Collector of Internal Revenue could have avoided this controversy by accepting the bid offered at his first lien sale or conducting his second, and possible subsequent sales, until he received a bid acceptable to him. Under the rule of *Stratton v. New*, 283 U. S. 318, the trustee could have appeared in the sale proceeding and seized for the estate any balance of the proceeds after the lien had been satisfied. The Collector of Internal Revenue did not see fit to do this, but instead entered the bankruptcy proceeding by consent. The effect of his appearance is set forth in Section 2195, Remington on Bankruptcy, 4th ed., Vol. 5, page 330:

> "Jurisdiction may be conferred on the bankruptcy court by the defendant's consent in cases wherein otherwise it has no jurisdiction, and if adverse claimants in possession of the property who would not otherwise be within the jurisdiction of the bankruptcy court, nevertheless voluntarily surrender custody of the property, or consent to the jurisdiction of the bankruptcy court, the question of ownership and all other questions in relation thereto, as, for instance, the extent, validity and priority of liens upon and interests in the property, may be tried out in the bankruptcy proceedings."

As the referee stated in his certificate, the Collector of Internal Revenue voluntarily relinquished possession of the physical assets to the receiver, who later, in his capacity as trustee, sold the assets at public auction. Possession by the trustee was not possession by the Collector of Internal Revenue, since the trustee was not the agent for the Collector of Internal Revenue but, as an officer of the Court, represented all the creditors. It was held in the case of *In re San Joaquin Valley & Packing Co.*, 295 Fed. 311, that the trustee was not trustee for the fully secured lien claims; he was trustee for the bankrupt and the unsecured creditors; that in bankruptcy proceedings these two classes of creditors stood upon a different footing, and that it was not necessary for the fully secured lien creditor to prove his claim, but he would subject the security or its proceeds to the payment of the lien.

As was stated in the brief of the United States in its first argument, pages 6-8, at the commencement of the bankruptcy proceedings, the priority of the lien of the United States over wage claims was clearly established. Respondent has never contended that Section 67(c) of the Bankruptcy Act in any way altered the full force and effect of the Collector's lien; it was valid before bankruptcy and after bankruptcy proceedings commenced. Had the receiver or trustee in bankruptcy obtained a Court order from the referee in bankruptcy and taken over the personal property of the bankrupt from the possession of the Collector of Internal Revenue, respondent would not maintain that the Collector of Internal Revenue lost the element of possession necessary to prevent the application of Section 67(c) of the Bankruptcy Act; in such case the possession of the lien claimant would be fixed and continuing before and after the commencement of the bank-

ruptcy proceeding. It is established law that when the bankruptcy court takes property from a lien holder and holds a sale of the property in the bankruptcy proceeding, the proceeds of the sale, less the trustee's reasonable expenses in conducting the sale must first satisfy the lien as against all creditors. In such a case the lien holder by force of Court order is before the bankruptcy court and his substantive rights cannot be altered.

But, as in this case, where the lien holder by his voluntary act and for his own reasons enters the bankruptcy proceedings, makes use of the bankruptcy court processes, makes use of the time and efforts of the receiver or trustee in bankruptcy and avoids the expense and bother of conducting his private lien sale outside the bankruptcy proceedings, the lien holder cannot avoid the full consequences of his voluntary act.

Judge Stephens in the opinion below gave consideration to this concept of law, stating:

> "In the instant case the government had actual possession, but it surrendered that possession by virtue of a bargain with the receiver without taking into account the wage and creditor claimants. The Act provides that wage claims come ahead of the government lien in distribution of the proceeds of sale of property not in possession of the government lien holder. The government lien holder must either sell the property under its lien or eventually surrender it into the bankruptcy proceedings. We find no authority whatever for the proposition that the government can turn the property over to the trustee under a consent based upon the receiver's assurance that the lien shall continue upon the property and also upon the money it may bring when sold as a part of the bankruptcy estate. It is our opinion that the wage claim-

ants had certain statutory rights at the inception of the bankruptcy proceedings, and such rights remained throughout the proceedings, modified by the actual possession of the assets. The fact, as is claimed, that the receiver could make the sale to better advantage is irrelevant, for the question is one of power and not of business judgment. The statutory requirements may not be disregarded through private agreements which affect others' rights without their consent."

Respondent urges that the Court below gave full credence to the intent of Congress in enacting Section 67c of the Bankruptcy Act. It was a matter of common knowledge that tax claims were consuming most of the assets in bankrupt estates to the exclusion of court costs and prior labor claims. In most instances the toil and labor of the employees of the bankrupt created or preserved those assets and in order to protect this innocent and deserving group Congress subordinated payment of certain lien claims, including statutory liens on personal property not accompanied by possession. The background of this legislation is set forth in Collier on Bankruptcy, 14th ed., Vol. 4. At page 157 it states:

"And under the Act of 1898 all liens valid in bankruptcy have precedence over unsecured claims entitled to priority under Sec. 64: only after the discharge of such liens were assets available for distribution, first to priority claimants, and second to other unsecured creditors having no priority. This general principle remains true under the Act of 1938, subject to the fact that Sec. 67c subordinates statutory liens under certain circumstances to debts having first and second priority under Sec. 64."

At page 235 it states:

> "The function of Sec. 67c is entirely different. In effect Section 67c says that *statutory* liens on personal property not accompanied by possession, and liens, whether statutory or not, of distress for rents, regardless of possession, are inferior to *all* administrative costs and expenses of the bankruptcy proceeding and wage claims, which are entitled, respectively, to a first and second priority under Sec. 64a. This principle whereby certain liens are subordinate to certain priorities is new to bankruptcy law, being first introduced by the Act of 1938. It is a statutory principle, which Congress introduced to provide a measure of much-needed protection, . . . (2) for wage claims in the interest of protecting a weak but deserving economic class, against the ravages of certain accumulated liens on the bankrupt's property." (Emphasis theirs.)

When the Collector of Internal Revenue entered the bankruptcy proceeding by consent and gave up possession of the property to the receiver, the statutory rights of the prior wage claimants to payment of their claims payment on the lien claims became fixed.

The facts show that the Collector *lost actual possession*. It was determined by the Court below and the Second Circuit in *City of New York v. Hall*, 139 F. 2d 935, that possession as used in Section 67c in the Bankruptcy Act means actual possession, not constructive possession. The brief of the United States alleges that the purpose of the requirement of possession is merely to give notice to employees that the property levied upon will not be available to satisfy wage claims. Respondent contends there is no reason or merit to such an argument, because notice or lack of notice means absolutely nothing to the ordinary

worker whose sole interest is to maintain his job by satisfying the demands of his employer and bringing home his pay check in order to feed and clothe his family. The worker does not care whether there has been a lien on his employer's property with or without possession, so long as he can stay on the job, his immediate concern is whether he is going to get his wages. Actually, the workers are in the most helpless position of all creditors, and Congress in the Bankruptcy Act and the various states in insolvency statutes have created laws attempting to protect this class. This Court has this month denied issuance of a writ of certiorari in the case of *Check v. The Division of Labor Law Enforcement,* ..... U. S. ....., and by so doing upheld a California statute granting lien rights to unpaid workers whose employer has made an assignment for the benefit of creditors. Congress in enacting Section 67c of the Bankruptcy Act merely added to and strengthened the priority payment rights of the employees of a bankrupt employer.

Both petitioner and the United States cite *Petition of International Harvester Co.*, 9 F. 2d 299 (C. C. A. 6), in which the court held that waiver of a prior lien could not be implied solely from the fact that a lienholder in possession surrender possession to the receiver after the filing of the petition in bankruptcy. The case is easily distinguished from the instant case in that no contention is made here that the Collector's lien was waived by his surrender of possession; all that the respondent is contending is that the lien, though valid after the surrender of possession, was deferred in time of payment to the prior wage claimants in accordance with the provisions of law.

II.

Any Private Agreement Between the Collector of Internal Revenue and the Receiver or Trustee in Bankruptcy Concerning the Attachment of the Statutory Lien to the Proceeds of a Trustee's Sale, When Possession of the Personal Property Was Voluntarily Transferred to the Receiver, Would Not Be Binding Upon the Prior Wage Claimants.

The Collector of Internal Revenue and the receiver in bankruptcy in the instant case made a private business arrangement; respondent in no way questions the propriety of such an arrangement and believes that it was honest and intelligent business practice. As a result of this business deal the bankrupt's property was sold for over $40,000.00 instead of $23,000.00, and the receiver in his capacity as trustee was enabled to earn fees legally due him. It was when the Collector of Internal Revenue attempted to use the terms of this private agreement in circumvention of statutory rights of the prior wage claimants that respondent entered the scene and has been vigorously fighting this contention ever since. Other than a case decided in a district court, *In re Lebed*, 35 Fed. Supp. 457, respondent knows of none other touching on this point in connection with Section 67c of the Bankruptcy Act. In that case a landlord's lien was involved rather than a tax lien. Two landlords, acting through a constable with a landlord's warrant, levied upon and seized the stock and fixtures of the debtor for accrued rent. Sale was stayed at the request of certain, but not all, of the creditors to permit the filing of an involuntary petition in bankruptcy. It was

then agreed that the landlords should have a lien on the funds derived from the sale in the hands of any receiver or trustee to the same extent as if they, the landlords, had exercised their right of sale prior to bankruptcy. The matter arose on a petition to review the order denying full priority to the landlords. The Court stated in part:

> "Finally the effect of the prebankruptcy agreement between the petitioners and certain of the creditors must be considered. . . . In the trustee's brief it is admitted 'had the landlord proceeded under the levy, there would not have been sufficient time within which to secure the necessary signers to an involuntary petition in bankruptcy before the sale could have been held by the landlord. Had he actually enforced the sale he would have had his money and the controversy would not have arisen. The fact is that the request for the extension has been greatly to benefit the bankrupt estate. The receiver sold the stock which had been levied upon for $1,800.00, but had the constable sold the same goods, it is extremely doubtful if a fund more than required to pay the landlord's claim of $540.00 would have been raised, so that from a strictly practical viewpoint, the bankrupt estate could pay the landlord's claim and still be more than a $1,000.00 ahead. The landlord is being penalized for the courtesy which was extended to present counsel for the trustee. The trustee, however, has a duty to perform to all of the creditors, and to submit the matter to the court with the fairest statement of facts possible.' In my opinion claimants are entitled to full priority for payment as against

those creditors who induced them to forego their right of sale under the agreement that their rights should be the same as if sale had been held. Of course, the rights of the other non-consenting creditors could not be affected by this agreement and, as to them the trustee's distribution of the assets should conform strictly with the provisions of the Bankruptcy Act."

On page 27 of his brief petitioner attempts to distinguish the *Lebed* case on the grounds that it involves a landlord's lien and the agreement was made before the commencement of the bankruptcy proceeding, whereas in the instant case the agreement was made after the commencement of the bankruptcy proceeding. Respondent does not believe that this argument should be given weight, since the principle of law established in the *Lebed* case is simply that under the provisions of Section 67c of the Bankruptcy Act non-consenting creditors are not bound by private agreements between lienholders and other creditors or the receiver or trustee in bankruptcy.

The Court below in its opinion fully considered the principle which respondent is here urging and stated:

"The statutory requirements may not be disregarded through private agreements which affect others' rights without their consent."

III.

Under Section 67(c) of the Bankruptcy Act, Administration Costs and Prior Wage Claims Are Jointly Given Priority Over Statutory Liens Not Accompanied by Possession.

Freeman Furniture Factories, Inc., v. Bowlds, 136 F. 2d 136, holds that where a creditor having a statutory lien invokes the jurisdiction of the bankruptcy court by joining in an involuntary petition in bankruptcy and by participating in proceedings for bankruptcy sale of assets in order to realize on the security, the costs of administration are properly chargeable to the fund produced by such sale, and the lien creditor cannot claim priority over such administration costs if there is no general fund free from liens for the benefit of the estate.

A like situation exists in the case at bar.

Respondent urges that the provisions of Section 67c of the Bankruptcy Act are mandatory upon a referee in bankruptcy in the case of statutory liens. The lien holder, where there is a sale free of liens and encumbrances, is chargeable with the actual costs of the sale plus costs reasonably incurred in the preservation of the property and the proportion of administration expenses that may be attributed to the sale. But respondent contends that in the case of statutory liens, where there has been a consent to jurisdiction of the bankruptcy court and a surrender of possession of the property, Section 67c of the Bankruptcy Act requires that *all* administrative costs and all prior wage claims come first in payment.

Since the referee allowed all expenses of administration as a priority over the Collector of Internal Revenue's lien, he was obliged to grant all prior wage claims the same priority. Such tortured reasoning as is used by the referee

in his certificate, "Your referee construed the words, 'Trustee's expenses, including costs of sale,' to mean the expenses of administration in the case, as allowed by the court," cannot circumvent the effect of a specific law of the Congress. The words of the act state, ". . . shall be postponed in payment to the date specified in Clauses (1) and (2) of Subdivision a of Section 64 of this Act, . . ." and no other meaning is apparent, except that these classes of debts are treated in the conjunctive; having allowed priority to one class of debt the referee must allow priority to the other.

Conclusion.

The Court of Appeals for the Ninth Circuit has held that the Collector of Internal Revenue must pay the legal price for voluntarily entering the bankruptcy proceeding. It is respectfully urged that the decision of the Court of Appeals for the Ninth Circuit should be affirmed.

Respectfully submitted,

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